

ASSESSMENT AND RECOMMENDATIONS

The underlying macroeconomic position is sound and policies should remain prudent

The Danish economy has a sound underlying macroeconomic position that has enabled it to cope well with the current international slowdown. Assuming that the projected recovery in global demand transpires, the pace of activity is expected to gradually pick up from its current rate of around 1½ per cent to around 2½ per cent growth next year, sufficient to reverse the recent up-tick in unemployment. With a current budget surplus of 1½ per cent of GDP and inflation running just above 2 per cent, the economy is well-balanced. But Denmark's output gap is currently smaller than that of the euro area and is likely to close sooner. Monetary conditions could thus be slightly looser than desirable given available capacity, leading to some risk of future overheating. Against this backdrop, any additional stimulus from fiscal policy would be unhelpful, so that tax cuts planned for 2004 to 2007 should be combined with restrained growth in public expenditure. Prudent macroeconomic policies are in place and need to be maintained. But the principal focus of policy in Denmark is appropriately set on addressing longer term economic challenges, and this is also the main focus of this *Survey*.

Ensuring fiscal sustainability by raising labour supply is the key policy challenge

The foremost challenge is to prepare for the rapid ageing of the population between now and 2040, when more than one in four adults will be over 65 years old. Gains in productivity should still be sufficient to generate continuing growth in national income per capita, but rising retirement income transfers and other age-related public outlays risk undermining fiscal sustainability. Curtailing expenditure growth may prove difficult, given the deep attachment to a comprehensive welfare state, while raising already high taxes would risk being counterproductive by making work even less attractive relative to leisure. The government's strategy therefore rightly focuses on ensuring fiscal sustainability by continuing to reduce public debt and expanding future labour supply through further raising participation rates and/or increasing hours worked, thereby both expanding the tax base and lowering the transfer burden. While rising living standards generally lead to an increasing preference for leisure, in Denmark the choice between work and leisure is heavily biased towards the latter by the tax/benefit system. Equity concerns have constrained the use of market-oriented incentives to achieve better labour supply outcomes. But the capacity for further expanding administrative measures instead may be limited. At least in the longer run, some shift towards more market-based instruments would help to safeguard the future of the welfare state.

Several avenues can be pursued to raise labour supply

Changing the relevant work incentives so as to encourage people to spend more time in work over their lifetime requires a multi-pronged approach. The government's "More People in Work" package makes a good start, but action is warranted in several other areas to address: late entry to the

labour market; a significant proportion of prime-age workers drawing public income support; lower participation among immigrants from less developed countries; early retirement; and lower average hours worked per person.

Passage through education needs to be accelerated

A significant proportion of young Danes are still studying into their late 20s, though many of them combine study with working. Lowering the age of full entry into the labour market would not only add to the effective labour supply but would also be cost-effective and welfare-enhancing. One contribution would be to refocus the voluntary 10th form at the end of compulsory education, currently attended by a majority of children, so that it instead provides more intensive remedial assistance to the small percentage of pupils that have fallen behind, while other students pass directly into upper-secondary education. In tertiary education, study paths tend to be drawn out and completed at a later age than in many other countries. Virtually all the costs of tuition are borne by the taxpayer, while generous study grants and subsidised loans are provided. But as additional qualifications provide a relatively modest boost to after-tax earnings in Denmark, charging significant tuition fees would probably be counter-productive and might discourage people from undertaking such education at all, despite the social return from having a well-qualified workforce. Instead, encouraging students to choose courses carefully, complete them expeditiously and start earning quickly may need to involve measures to tighten the provisions of the grants and loans scheme. These could include shortening the length of time for which study assistance is provided to more closely reflect the minimum time required to complete the study programme, linking continued support to passing courses, and adjusting the mix of income support from grants to loans.

Economic incentives to work need further strengthening

Participation rates could be boosted further, even for people of prime working age. The “More People in Work” scheme streamlines the management of unemployment but the elements addressing the weak economic incentives to work are confined to a sub-group of those receiving social assistance. The government’s stated desire to promote self-reliance is undermined if the net gains from taking a job are meagre, and even in some circumstances negative. Unemployment insurance and cash benefits are high relative to other OECD countries, particularly for those whose earnings prospects are relatively modest. The earned income tax credit that will be implemented as from 2004 should strengthen the incentive to move into work somewhat. Such incentives could be strengthened further, without attendant budgetary costs, by tightening eligibility and/or gradually reducing benefit rates, through:

- Shortening the length of unemployment spell covered by unemployment insurance benefits;
- Calculating unemployment insurance benefits on the basis of income earned over the previous 12 months, thereby gradually reducing benefits as the unemployment spell lengthens. This would strengthen the incentive to accept a job offer even if it involves a lower rate of pay and would also to some extent limit the capacity for seasonal workers to misuse the system;

- Instituting longer work requirements before qualifying for full unemployment insurance benefits;
- Making further adjustments to the formulae used to calculate cash benefits so as to provide a larger margin between income on benefits and potential income from work.

The effective retirement age needs to rise

Keeping the effective dependency ratio as low as possible requires every effort to encourage those who are able to work to do so. Despite this, the average effective age of retirement has fallen somewhat over the last two decades, while life expectancy has risen: thus retirement represents a steadily rising share of adult lifetimes. At the same time, the voluntary early retirement scheme pays participants up to three or four times more in benefits than the net present value of their contributions; this sends the wrong signal by making early retirement more attractive. Improving the incentives to work by actions on several fronts could lead to a significant increase in the effective retirement age:

- Giving consideration to abolishing the voluntary early retirement scheme altogether, noting that other systems already take care of people unable to find work or with reduced work capacity, or, as a second best, making it a strictly defined-contribution system.
- Applying activation measures to all workers right up to the statutory age of retirement to signal clearly that people are expected to continue to work.
- Ensuring that other forms of income support such as early retirement (disability) pensions are not used as an alternative channel for permanent exit from the labour force.

Reversing the earlier reduction in the statutory retirement age from 67 to 65, and then changing the statutory age, along with the age criteria for any early retirement scheme, in line with increases in life expectancy would also help to ease the impact of ageing on public finances and make room for further supply-oriented income tax cuts.

Immigrants need to be better integrated

An inflow of migrants could, in principle, also alleviate the ageing burden. But Denmark's experience with migrants arriving in the country since the 1960s has been very mixed. Highly skilled immigrants from more developed countries have generally integrated well, work to support themselves and make a positive lifetime contribution to public finances. Well-qualified immigrants from less developed countries have had more difficulty in getting work commensurate with their apparent educational attainment. Low-skilled immigrants from such countries tend to be poorly integrated and are more often reliant on state assistance, creating a net drain on the public purse over their lifetimes. Furthermore, although descendants seem to be doing better than their parents, they still tend to lag behind native Danes. In response to these challenges, recent revisions to Denmark's migration policy have, in particular, involved:

- Stemming the inflow of low skilled immigrants without demonstrated means of supporting themselves;

- Putting more effort into integrating foreigners, including those already in Denmark, helping them first to become self-reliant and ultimately to attain economic outcomes indistinguishable from those of native Danes;
- Easing entry for highly skilled immigrants.

Attracting more highly skilled migrants will be difficult

Denmark's entry policies are now somewhat closer in spirit to the more selective immigration policies already practised by some other OECD countries. But the government can do little more to attract highly skilled foreign workers than remove obstacles to their entry and make it easier for immigrants with foreign qualifications to use their skills. Denmark will remain at a disadvantage in competing to attract such foreigners because of language barriers, compressed wages and high taxes. In principle, these same factors could encourage well-educated Danes to emigrate, although there is little evidence of this happening on a large scale thus far. In any case, what is important for the sustainability of public finances is the net migration balance of highly skilled workers, irrespective of nationality.

Low skilled immigrants find it hard to integrate

Lack of education and skills is a particular problem for a significant proportion of immigrants because low paid, unskilled jobs that migrants might take up in other countries are relatively scarce, once again because of the compressed wage structure and high tax wedges. This lack of suitable jobs makes it harder for these immigrants to take a major step towards full integration. At the same time, it is difficult to envisage such low-wage jobs being created while unemployment benefits and welfare payments remain high and collective agreements embody high negotiated minimum wages. Integrating these groups into the labour market may therefore require a combination of greater efforts to improve skills, stronger activation policies and perhaps also time-limited subsidies, all of which have budgetary costs.

Language skills are crucial for integration

Improving educational attainment and local language skills are both key determinants of integration. But it is difficult to obtain Danish qualifications without a solid language base. Good Danish language skills are also more important if the jobs available require a reasonable amount of communication and interaction with others. At the same time, immigrants tend to cluster together, reducing both the need and the opportunities for learning the host language in daily life. Thus, a countervailing insistence that immigrants make every effort to learn the language, matched with provision of suitable facilities, would help to speed integration. Recent reforms have already moved in this direction: the introduction programme for new arrivals and increased emphasis on activation should both help, although such efforts need to be carefully monitored and evaluated to ensure they are delivering cost-efficient results. More consistent application of activation efforts across municipalities, along with wider diffusion of best practices might also help to improve integration outcomes.

Greater efforts should be made to lift the educational attainment of descendants

Special efforts to help improve the opportunities for second-generation immigrants are also necessary in order to avoid perpetuating the disadvantages faced by their parents. The government's increased emphasis on pre-school in Danish for non-native children is appropriate: earlier remedial action as soon as children start slipping behind in

the education system would also help. It is still too early to determine how large a labour market gap will remain between descendants and their native counterparts, as most adult descendants are still young. Nevertheless, active promotion of the value of educational achievement for immigrants, backed up with wages that more fully reward human capital, might also prompt ethnic communities to more actively encourage their children to succeed in the Danish education system.

Ensuring fiscal sustainability has become harder

Labour supply, the budgetary options available in the short and medium term, and ultimately, the sustainability of government finances are intimately related. Denmark is in the enviable position of currently having a structural budget surplus of close to 2 per cent of GDP, although it will have to contain expenditures as intended in order to maintain this position over the coming years. The task of maintaining sustainability is not made easier by the nature of the tax cuts scheduled for 2004 to 2007, the erosion of revenues due to the “tax freeze”, and widespread expectations of increasing public service standards.

Tax cuts should focus more tightly on reducing high marginal tax rates

High marginal tax rates on labour income reduce the attractiveness of choosing work over leisure for many employed. The agreed tax cuts, once fully implemented, will mitigate this problem to some extent. They raise the threshold for the intermediate tax rate and provide an earned income tax credit to all workers. Yet the top tax rate remains 63 per cent and still applies to around 40 per cent of full-time workers. Raising significantly the threshold for the top tax rate, or even abolishing that tax bracket altogether would involve immediate budget costs of around 1 per cent of GDP, but these costs would be attenuated in the longer run by the stronger work incentives created for higher-skilled workers. In contrast, the announced tax measures will increase after-tax incomes for all employed by a modest amount, and significantly lower marginal tax rates for around one-third of workers. These measures have a different distributional impact, but are estimated to generate less extra employment for the revenue foregone than could have been achieved by raising the threshold for the top tax rate.

The “tax freeze” limits expenditure growth, but is also a straightjacket

The government’s “tax freeze” is designed to constrain public expenditure growth and reduce the overall tax burden. Its terms are very strict, which makes the government’s commitment credible and easy to monitor. But it erodes real revenue from property and excise taxes that are set in nominal terms, which — even though the reduction of excise duties and, to a lesser extent, property tax also have some positive indirect impact on the labour supply decision — puts an increasing proportion of the overall tax burden onto labour income. Having a rule adjusting nominal taxes in line with inflation while gradually cutting income taxes would have a greater impact on labour supply, and hence on public finances. Likewise, better economic outcomes could be obtained by more loosely interpreting the freeze to allow revenue-neutral tax packages that would shift more of the tax burden from labour income to immobile factors such as property, although this would reduce the transparency of the tax freeze to some extent.

Yet it should work to constrain spending by

A key objective of the tax freeze is to avoid increases in the average income tax rate of local authorities. This in turn implies a stricter expenditure

lower levels of government

prioritisation by the local authorities, who are responsible for a large proportion of public outlays. Since local authorities set their own income taxes and can thus undermine national objectives to reduce the tax burden on labour, it makes sense to limit their room for manoeuvre. Until this year, the government lacked an effective instrument, since budget agreements negotiated with associations representing local authorities were not binding on individual municipalities or counties. However, it has now added a sanctions mechanism to encourage co-operative behaviour among local authorities. This should ensure that average local tax rates are kept stable, consistent with the “tax freeze”, but it remains to be seen how this will work out over time as authorities gain experience in “playing the game”. One possible outcome would be that the required coordination to balance tax cuts and tax increases fails to develop, with the result that current variations in local tax rates become locked in. This would effectively negate the rationale for local taxing powers and might call for a different mechanism, for example, the use of tradable tax permits.

Measures to slow growth in public outlays need to be spelt out

Real public consumption has tended to creep upwards over the years, and it could prove difficult to slow the pace in the face of public expectations of higher public service standards in the future. While the tax freeze and the fiscal surplus target together should put greater downward pressure on spending, measures and/or mechanisms to pinpoint where and how spending will be trimmed remain unspecified. Allowing more extensive application of user charges to cover part of the cost of publicly supplied services could help to make provision more efficient and responsive. It would also be prudent to reconsider various benefit schemes or to prepare for additional trimming of outlays to ensure fiscal sustainability if the assumed increase in labour supply between now and 2010 fails to materialise. This requires a shift in approach, since Denmark has so far focussed on preparing to meet its future spending obligations by maintaining budget surpluses and reducing public debt, rather than acting directly to reduce those future obligations themselves.

Climate change policy has been placed on a more efficient basis...

Another aspect of sustainable development concerns the environment, where Denmark has set high ambitions, and a stronger focus on cost-effectiveness is now emerging. A number of policies for reducing greenhouse gases have entailed significant costs, but the government's new strategy to counter climate change emphasises using the EU emission trading system to minimise the cost of lowering emissions. Assistance to the wind-power programme is now limited to the government's estimate of the externalities stemming from carbon emissions. Finally, it rules out additional measures in areas where taxation is already high. These steps are welcome. However, the government will need to assess carefully the quantity of emissions allowances that will be granted in order to ensure that Denmark meets its burden-sharing agreement. In addition, policies could still be improved by ensuring that abatement costs are more uniform across the economy, using the allowance price in the EU trading system as a benchmark. Consideration should also be given to finding a way to capture a significant part of the value of such allowances for society as whole, thereby providing the revenue to reduce a number of distorting taxes.

... but further re-orientations of policies are required in other areas

Further efforts in achieving sustainable development in an efficient fashion are also warranted in other areas including:

- To lessen nitrogen concentrations in waterways and coastal areas, economic instruments, such as taxing commercial fertiliser inputs with rebates based on the nitrogen content of output, should be used. Tax rates should be set on the basis of cost-benefit analysis.
- To deal with waste more efficiently, a more rational and coherent system is needed. This should be based on rigorous assessment of the costs and benefits of alternative disposal methods. The use of economic instruments, such as the packaging tax, should be realistically calibrated according to the corresponding environmental externalities, with an emphasis on the use of incentives rather than regulations.

Summing up

Denmark is weathering the international slowdown reasonably well, and the pace of activity should pick up over the remainder of this year. The underlying macroeconomic situation is sound, although being slightly out of step with the euro area monetary conditions may lead to a risk of future overheating. The announced tax cuts could provide undue stimulus to the economy at the same time, if not balanced by appropriate expenditure restraint. Denmark's main challenges in coming years involve changing incentive structures so as to expand the labour supply. This would raise productive capacity and keep the effective dependency ratio within manageable proportions over the longer term, thereby ensuring fiscal sustainability despite increasing pressure arising from changes in the composition of the population. Current policy settings involve high levels of income support in one form or another to a proportion of recipients who could rely more extensively on their own resources, given a better set of incentives to do so. Specific measures could help to speed up entry into the labour force, provide greater economic rewards for working, and postpone retirement. Special efforts could also make it easier for immigrants to become more self-reliant and integrate more quickly and effectively in the future. In sum, a variety of measures — some already taken and others recommended in this *Survey* — would help the economy to continue on a sustainable path and improve overall outcomes.